

Letter of Findings Number: 02-20160619
Adjusted Gross Income Tax
For Tax Years 2009 through 2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Electrical product distributor was properly denied Indiana research tax credits because it failed to provide documentation to substantiate the credit. Further, while the Department must use federal adjusted income as reported on the amended returns as its starting point in calculating audit assessments, the Department used its discretion and accounted for the IRS settlements in those calculations.

ISSUES

I. Adjusted Gross Income Tax—Research Expense Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800 (Ind. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *United States vs. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *Shami v. Comm'r*, 741 F.3d 560 (5th Cir. 2014); *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957); *Vanicek v. Commissioner*, 85 T.C. 731 (1985); *Fudim v. Commissioner*, T.C.M. 1994-235; *Suder v. Commissioner*, T.C. Memo 2014-201, 2014 WL 4920724 (U.S. Tax Ct. 2014); Treas. Reg. § 1.41-2 (2001); Treas. Reg. § 1-41-4; *IRS Audit Technique Guide*, 2005 WL 405783 (June 2005).

Taxpayer protests the partial disallowance of claimed research expense credits.

II. Adjusted Gross Income Tax—Calculation of Assessments.

Authority: IC § 6-3-1-3.5; I.R.C. §62.

Taxpayer claims that the Department made a mathematical error in calculating proposed assessments.

STATEMENT OF FACTS

Taxpayer is an electrical product distributor with several locations throughout Indiana. Taxpayer is comprised of three divisions: an automation division, an information technology ("IT") division and a manufacturing division. The automation division designs and installs "motion control systems, sensor systems, operation interfaces, and industrial plant-wide data collection services." The IT division "designs business networks and network security systems, develops system backup solutions, and provides data collection and migration solutions." Finally, the manufacturing division "designs and installs manufacturing process control systems including data monitoring and reporting systems, inventory tracking systems and product traceability systems."

Taxpayer hired an independent third party ("Consultant") to complete a Research and Development Tax Credit Study ("Study") for fiscal years 2008 through 2011. Taxpayer used that Study to claim the Research Expense Credit ("REC") for fiscal years 2009, 2010, 2011 and 2012 on both its federal and Indiana income tax returns. These RECs were comprised of wage expenses only. In 2015 the Indiana Department of Revenue ("Department") conducted an audit of Taxpayer's books and records. The initial period of review was fiscal years ending March

31, 2012, March 31, 2013 and March 31, 2014. According to the audit report, "During this initial review . . . it was learned that the [T]axpayer filed amended federal and state returns for FYE 03/31/2009, FYE 03/31/2010 and FYE 03/31/2011 to claim the federal research credit and the Indiana REC." The Department also learned that Taxpayer was subject to an Internal Revenue Service ("IRS") examination for tax years 2008 - 2011. As a result of this examination, "[T]axpayer stated the IRS initially disallowed the federal credit in full but the IRS later allowed a percentage of the credit originally claimed to resolve the case." Specifically, the IRS allowed sixty percent of the credit and disallowed forty percent.

As a result of the audit, the Department made adjustments to Taxpayer's 2008 - 2013 Indiana tax returns. These adjustments resulted in proposed assessments for tax years 2010 through 2012. Taxpayer disagreed with these adjustments and filed a timely protest. An administrative hearing ("Hearing") was conducted during which Consultant, acting as Taxpayer's representative, explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax—Research Expense Credits.

DISCUSSION

The Department conducted an audit of Taxpayer's books and records for tax years 2012 - 2014. During the audit, it was learned that Taxpayer had been subject to an IRS examination for tax years 2008 - 2011. In that examination, Taxpayers opted for a "fast track settlement" in which the IRS disallowed forty percent of the REC claimed and allowed sixty percent. The Department's audit report agreed that "A review of the [T]axpayer research projects and documentation revealed that [T]axpayer was conducting qualified research." However, because the amount of the qualified research expenses ("QREs") claimed by Taxpayer were the result of estimated wage participation percentages that "could not be verified[.]" the audit reduced the Indiana RECs claimed by forty percent pursuant to the IRS settlement.

Taxpayer filed a timely protest stating that it "disagrees with the Department's determinations in part because [Taxpayer] believes the [audit] team has a misplaced reliance on the settlement negotiations between [Taxpayer] and the IRS, that [Taxpayer] is entitled to the full REC credit based on the requirements under the law, and because the adjustments contain computational errors that materially affect the Taxpayer." Taxpayer points out that "The settlement reached with the IRS does not, in any way, reflect an acquiescence by the Taxpayer or an acknowledgement by the Taxpayer that the full claimed amount was inaccurate . . . the settlement amount was reached solely for the purposes of convenience." As such, Taxpayer believes that it is entitled to the full amount of Indiana RECs claimed.

As a threshold issue, it is a taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

"[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Therefore, when the statute is plain and unambiguous there is no need to delve into the legislative history of the statute.

Our settled procedure of statutory construction begins with a determination as to whether the legislature has spoken clearly and unambiguously on the point in question. If so, our task is relatively simple: we need not "delve into legislative intent" but must give effect to "the plain and ordinary meaning of the language." *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800,803 (Ind. 2012).

(Internal citation omitted).

Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits available under Indiana tax law is the REC under IC § 6-3.1-4-1 *et seq.* The 2003

statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period. IC §6-3.1-4-4.

Treas. Reg. § 1.41-2(d) (2001) states:

(1) Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

In order to obtain the benefit of the credit, both Indiana and federal law require that a taxpayer maintain and produce *contemporaneous* records sufficient to verify those credits. "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)). Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009).

Under IC § 6-8.1-5-4 "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability. . . ." In addition, Treas. Reg. § 1-41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

The IRS's *Audit Technique Guide*, 2005 WL 405783 (June 2005) provides useful guidance in relation to the information necessary to verify research expense credits. The Guide states:

Substantiation and Record Keeping: Under the final regulations, **a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.** See I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

The Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.

The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude [] of their own making." **Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof.**

2005 WL, at *24. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, [http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-\(i.e.-Research-Tax-Credit\)-IRC-§ 41](http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-§ 41) (last visited January 17, 2018) (**Emphasis added**).

Thus, while estimation methods are permissible when computing the amount of the REC, those estimates must be backed by documentation which verifies the amount of the expense. To reiterate the IRS' guidance, "taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof."

Here, Taxpayer protests that the Department erred in disallowing a portion of the REC for the years at issue. The Department disallowed this portion of the REC because "[T]axpayer estimated the wage participation percentages [and] the amount of QREs claimed by the [T]axpayer could not be verified" Therefore the IRS guidance bears repeating: "[A] taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In situations in which precise detail is lacking and in which the Taxpayer "estimates" the amount of the credits, "[T]axpayer must have factual support for every assumption underlying their estimates to meet their burden of proof." The analysis that follows is not whether Taxpayer qualifies for the REC, but whether Taxpayer's estimates were acceptable under the law.

Case law provides some guidance as to whether or not estimates of QREs are acceptable when claiming the REC. In the case of *Cohan v. Commissioner*, the Circuit Court of Appeals for the Second Circuit allowed taxpayer entertainment and travel expenses to be estimated even though taxpayer had kept no records of the expenses. The court reasoned that "Absolute certainty in such matters is usually impossible and is not necessary . . . It is not fatal that the result will inevitably be speculative." *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930). In explaining its decision, the court stated that "there was obviously some basis for [the] computation . . ." and asked the Board to "reconsider the evidence."

From the *Cohan* case came a "longstanding rule . . . that if a qualified expense occurred, the court should estimate the allowable tax credit." *McFerrin*. That rule has been qualified by several courts. As the United States Court of Appeals for the Eighth Circuit noted, "We believe that considerable discretion exists in the application of the *Cohan* rule, and that such rule should be applied only in cases where the taxpayer has clearly shown that he is entitled to some deduction and that uncertainty exists only as to the exact amount thereof." *Oates v. Commissioner of Internal Revenue*, 316 F.2d 56, 59 (8th Cir. 1963). The United States Court of Appeals for the Fifth Circuit, in finding that the record *did not* contain a reasonable basis upon which an estimate of taxpayer's allowable tax credit could be made, noted that even though the Tax Court "might have considerable latitude in making estimates of amounts probably spent," the *Cohan* rule "certainly does not require that such latitude be employed." *Shami v. Comm'r*, 741 F.3d 560, 569 (5th Cir. 2014) (citing *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957). Further, "Our decision in *Williams* explicitly held that the Tax Court 'may not be compelled to estimate even though such an estimate, if made, might have been affirmed.'" *Id.* In other words, though a court *may* estimate allowable tax credits under *Cohan*, it is not *compelled* to do so.

If a court does apply the *Cohan* rule, "a reasonable basis must exist on which the Court can make an estimate." *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957). As stated by the United States Tax Court, "While it is with the purview of this Court to estimate the amount of allowable deductions where there is evidence that deductible expenses were incurred, **we must have some basis on which an estimate may be made.**" *Vanicek v. Commissioner*, 85 T.C. 731 (1985) (**emphasis added**). "For the basic requirement is that there be sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose." *Williams v. United States*, 245 F.2d 599 (5th Cir. 1957). In a 1994 United States Tax Court case, the court estimated time spent on research and development based on both taxpayer testimony and "other evidence in the record." *Fudim v. Commissioner*, T.C.M. 1994-235. A recent United States Tax Court case

allowed a taxpayer to estimate its wage QREs, but only after several days of testimony by several witnesses taken under oath which was supported by "documentary evidence in the record." *Suder v. Commissioner*, T.C. Memo 2014-201, 2014 WL 4920724 at *24 (U.S. Tax Ct. 2014). Therefore, estimates of QREs are acceptable, but only to the extent that they are supported by testimony and documentary evidence.

The QREs claimed were the result of Consultant's Study. The audit report notes that the Study identified three hundred seventy-seven total projects within Taxpayer's divisions that contained research and development activities. Using statistical sampling, Consultant chose thirty-five manufacturing projects, thirty IT projects and thirty automation projects to review for qualified research activities. Consultant "determined from manager interviews and project documentation, that all manufacturing sampled projects contained qualified research, that [twenty-five] of the [thirty] sampled projects for the IT division contained qualified research and [nineteen] of the [thirty] projects for the automation division contained qualified research." Using those results, Consultant developed "rescaling factors" for each division to capture percentages for all projects.

The audit report notes and Taxpayer confirmed, that "[T]axpayer did not have a job costing system to track time expended toward specific activities or individual projects." Therefore, Consultant used "interviews with company managers and project documentation to estimate employee qualified research participation percentages." To determine the QRE for each tax year, estimated employee participation percentages were multiplied by each employee's gross wages and then by the rescaling factor.

For tax years 2008 through 2011, Taxpayer includes at least a portion of the wages for thirty employees in its calculation of the REC. Taxpayer divided these thirty employees into groups according to job title and function and provided summaries of the groups' activities. Of the thirty employees included in the REC, Taxpayer claimed that four fell under "Substantially All" provision of Treas. Reg. § 1.41-2(d) (2001), meaning that all of those employees' income was included in the REC. As for the remaining twenty-six employees, Consultant explained in the hearing that they based the employee participation percentages largely on the knowledge of key management members, particularly the President of the IT division ("President"). According to Consultant, the President "determined allocations based upon his direct experience of employees' activities, their respective roles, and their respective responsibilities." Further, emphasizing the President's credibility in allocating employee time, Consultant noted that the President "worked directly with many of the employees providing input into the development of the design on the projects."

Taxpayer asks that the Department accept that its employees - including supervisors, engineers, technicians, sales people and purchasing employees - engaged in research activities and that it can reliably document the amount of time these employees engaged in those activities, despite the fact that Taxpayer did not have a job tracking system in place for the years at issue. Therefore, the estimates are not based upon documentation tying each employee's work to individual projects; rather, Taxpayer estimates percentages of qualified work based upon a category in which the employee's job title falls. For example, all four automation engineers were estimated to have spent thirty-nine percent of their time designated to qualified research for all four years of the study (2008 - 2011). Three software engineers were estimated to have spent ninety-three percent of their time doing qualified research for all four years, and one was estimated to have spent seventy percent of their time doing qualified research. Field technicians and design/sales engineers had varying estimates. All eight field engineers were estimated to have spent twenty-eight percent of their time doing qualified research for all four years at issue, with two exceptions in which an individual's estimate was thirty-five percent for one year. Technical support employees' estimates varied as a group, but each individual had the same percentage applied all four years. Management again had the same percentage applied to all four years as did sales and purchasing.

Overwhelmingly, the estimates presume that each employee spent the same percentage of time on qualifying research projects for each year at issue. These estimates are based on employee interviews and management knowledge several years later. The only supporting documentation provided by Taxpayer at the hearing were quarterly reports stating how many employees worked at each Taxpayer location and the total wages at each location. As stated in the Audit Techniques Guide, "[t]axpayers must have factual support for every assumption underlying their estimates to meet their burden of proof." Self-serving statements from Taxpayer, without any other supporting documentation to form the basis of those estimates, are not sufficient factual support.

While the audit agrees that Taxpayer was conducting qualifying activities in some of the sampled projects, Taxpayer failed to establish that its employee's conducted research to the extent claimed. By its own admission, Taxpayer did not prepare documentation "before or during the early stages of the research project" to support the amount of RECs claimed. Thus, Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) to show that the proposed assessments were wrong, especially given that the Department's audit did not deny all of the credit.

FINDINGS

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax—Calculation of Assessments.**DISCUSSION**

For Indiana income tax purposes, the presumption is that taxpayers properly and correctly file their federal income tax returns as required pursuant to the Internal Revenue Code. Thus, to compute a taxpayer's Indiana income tax, the Indiana statute refers to the Internal Revenue Code. IC § 6-3-1-3.5(a) provides the starting point to determine the taxpayer's taxable income and to calculate what would be their Indiana income tax after applying certain additions and subtractions to that starting point. Per the statute, the starting point for calculating Indiana adjusted gross income is adjusted gross income as defined by I.R.C. § 62. In other words, the starting point for calculating Indiana adjusted gross income is a taxpayer's federal adjusted gross income.

During the audit the Department discovered that Taxpayer filed amended federal and state returns for fiscal years ending March 31, 2009, 2010 and 2011. The Department also discovered that Taxpayer was subsequently subject to an IRS examination for tax years 2008 - 2011 which resulted in a forty-percent disallowance of the federal credit through settlement. Taxpayer believes that the Department "should [use] the adjusted taxable income as the result of the IRS settlement" as the basis for its audit assessments.

While the IRS and Taxpayer are free to reach any settlement they find acceptable at the federal level, such a settlement only represents an agreement to pay/accept less than initially assessed and the Department is not beholden to incorporate the terms of the settlement at the state level. Further, Taxpayer did not reference any statute, regulation or court case which compels the Department to use a settlement amount between the IRS and Taxpayers as the basis for determining Indiana adjusted gross income. The Department must therefore start with the federal adjusted gross income as reported by Taxpayer on its amended return. It is clear from the audit report that the Department did indeed calculate the audit assessments based on the figures reported in the amended federal return, and then made adjustments for the results of the IRS settlement on the state return after starting with the federal adjusted gross income. Therefore, Taxpayer's argument is denied.

FINDING

Taxpayer's protest is denied.

SUMMARY

Taxpayer did not provide sufficient factual support to validate its estimates of the claimed Indiana RECs. Additionally, Taxpayer's argument regarding the calculation of audit assessments is denied. The Department accounted for the IRS settlement in its calculation of audit assessments out of fairness; it was not required to do so.

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